Financial Meltdown: How Toxic the Fallout in Connecticut?

BY STEVEN P. LANZA

The ongoing financial meltdown threatens to spawn the most severe economic slump in several business cycles, possibly the worst since the Great Depression. As in the early 1990s following the savings and loan crisis, ground zero this time is also in financial activities, and the weakness extends beyond banks to brokerages, trusts, insurers, and realtors. The pain is certain to spread beyond these industries to the general economy. Financial activities leave a large footprint in the Nutmeg State, making it particularly vulnerable to a downturn originating in this sector. What are the causes of the meltdown and how toxic is the fallout to which the state may be exposed?

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ORIGINS OF A CRISIS

The current financial crisis has its roots in the debris of the dot-com boom that went bust earlier this decade. To prod the economy out of recession, the Federal Reserve slashed interest rates to historically low levels and, buoyed by a flood of savings from emerging nations, kept them there for years. Mortgage rates plunged, people snatched up real estate and prices took off. Despite warnings of an emerging speculative bubble, Alan Greenspan's Fed was reluctant to close the monetary spigot. Perhaps as significant, it was philosophically averse to beefing up regulatory oversight of financial markets.

With interest rates at rock bottom, mortgage lenders began offering loans to more marginal buyers. Thus were born the now infamous subprime mortgages, extended with little or no money down and with low teaser interest rates that would later adjust to higher levels. Many buyers planned to avoid the rate resets by reselling their homes at a profit or, flush with equity, refinancing at a lower fixed rate. Many existing owners turned their homes into ATMs by taking out home equity loans to finance other investments or consumer purchases.

In this low-rate environment, investors sought higher returns on their money. Wall Street got into the act by pooling mortgages of various kinds (that mortgage lenders were eager to resell to intermediaries) and issuing mortgage-backed securities whose values derived from the principal and interest payments of the underlying loans. However dubious their lineage and difficult to price for resale, credit rating agencies routinely assigned these securities AAA ratings.

Eventually, as buyers became increasingly overextended and teaser rates expired, mortgage delinquencies and defaults soared, home prices collapsed, and the values of those mortgage-backed securities came crashing down. The consequent solvency problems caused credit markets to seize up, and even healthy businesses were loath to lend to one another for fear of unknown skeletons that might be lurking in their portfolios.

Exposure to mortgage-backed securities sounded the death knell for some of the most venerable names in the financial world. Bear Sterns and Merrill Lynch were swallowed up by heartier institutions, and Lehman Brothers disappeared altogether. The federal government put new capital into Fannie Mae and Freddie Mac, and then assumed control. Insurance giant AIG, on the hook for the credit default swaps it sold to investors seeking a hedge against losses in mortgage-backed securities, sold the U.S. government a substantial claim on its equity in return for a huge loan to stay afloat.

BLAST FROM THE PAST

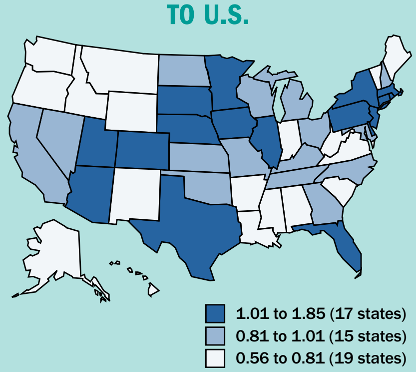
The financial meltdown has elicited many comparisons with the wrenching gyrations the U.S. economy underwent during the Great Depression. But there are, thankfully, significant differences. Then, the market was in free fall for years, plunging by 89% between September 1929 and July 1932. Now the venerable Dow-Jones Industrial Average is down only 40%, though the drop has occurred within the short space of one year. Then, unemployment reached 25%, and the economy surrendered one entire year's worth of output between 1929 and 1934. Now unemployment stands above 6%, and the latest GDP numbers are off only a fraction of a percent, though the smart money is betting on worse news to come.

This time around, the policy response to the current crisis has been more surefooted. Then, President Hoover raised taxes and the Federal Reserve tightened the money supply, greatly aggravating the severity of the recession. Now, no one's talking about boosting taxes any time soon, and monetary policy has been eminently accommodative. FDIC insurance has so far assuaged nervous bank depositors, and automatic stabilizers like unemployment insurance and the earned income tax credit, which didn't exist in the 1930s, are quietly doing their work.

What's more, whereas during the Depression the government embraced extreme efforts at resuscitation only late in the process, this time policy makers are intervening relatively early on, and heeding the lessons of last century's crisis. Fed Chairman Ben Bernanke, a student of the Great Depression, credits two Depression-era institutions with helping to lift the country out of its economic funk. The Reconstruction Finance Corporation (RFC) made loans and even bought equity stakes in banks and other businesses, and the Home Owners' Loan Corporation (HOLC) refinanced mortgages to prevent foreclosures. Strains of both can be found in the current rescue effort.

Although Treasury Secretary Paulson's original bailout proposal was limited to purchasing the toxic assets held by financial institutions, in its final form the program allowed the Treasury to buy equity stakes in and help recapitalize banks and other players, much as did the RFC. The financial infusion is aimed at ending the institutional hoarding of cash and getting credit flowing through the system again. And the Hope for Homeowners (H4H) bill, like HOLC, is meant to

CT AMONG TOP STATES IN SHARE OF FINANCIAL ACTIVITIES RELATIVE TO U.S.



SOURCE: *The Connecticut Economy*, based on data from Bureau of Economic Analysis (BEA)

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help keep at-risk homeowners in their homes, reduce the overhang of housing, and give prices a chance to firm up. But the plan, which guarantees banks 90% of the newly appraised value of a home in exchange for converting an existing mortgage into a traditional 30-year fixed-rate loan and a government cut in any gain on a future sale, is entirely voluntary.

BEAN COUNTING

Connecticut has a high concentration of jobs in financial activities. U.S. Bureau of Economic Analysis (BEA) data for 2007 show that more than 7.5% of jobs in the state were in the financial activities sector, versus just 4.7% nationally. The ratio of these percentages (7.5% / 4.7%), the so-called location quotient (or LQ), comes to 1.61. Any number above 1.0 indicates that a region is relatively more specialized in an industry than is the U.S. as a whole. Thus Connecticut has a 61% greater concentration of economic activity in finance than average (see map p. 5), ranking us second in the country after Delaware (1.84), but well ahead of New York (1.38). Our centerfold, which maps financial activity LQs by town in Connecticut, shows the heavy concentration of the industry in the Stamford and Hartford areas.

The financial activities sector is composed of four smaller sub-sectors: banks, securities, insurance, and funds-&-trusts. Connecticut's LQ exceeds 1.0 in each of these sub-sectors except banking (0.90). (Connecticut also is about average (LQ = 0.97) in the finance-related real estate sector, which was arguably the first domino to fall in the current financial collapse.) The Constitution State leads the nation in the concentration of insurance jobs (2.09), and ranks second in securities (1.89) and third in funds-&-trusts (2.26).

Regional economic theory suggests that industries with location quotients greater than 1.0 serve as engines of economic growth. LQs greater than 1.0 signify a level of production that is more than sufficient to supply local demand for industry output. The surplus can be exported to other states and other countries, earn industry workers high incomes, and spur a beneficent "multiplier process" that creates new jobs and higher incomes for others within the region, as these industry workers spend their earnings in the local economy.

BEA calculates industry multipliers for each state in the country. A regression of these multipliers against state LQs across all the finance subsectors shows that an "average" state, with an LQ of 1.0, will have a financial activities multiplier of about 2.2. Thus, adding a job in banking, securities, insurance or the related real estate sector adds another 1.2 jobs to the state's economy for a total of 2.2 jobs altogether. For funds-&-trusts, though, the statistical evidence suggests a significantly higher multiplier of 2.9. So a new job in this sector adds nearly two additional jobs elsewhere in the economy.

States that have a higher-than-average concentration of jobs in financial activities are apt to have larger multipliers in these industries. States with financial LQs of 2.0, for example, tend to have multipliers of about 2.6 rather than 2.2, so increasing the LQ by 1.0 increases the multiplier by 0.4. Insurance and funds-&-trusts are even more responsive to an increase in industry concentration. Raising the LQ from 1.0 to 2.0 in insurance increases the multiplier from 2.2 to 3.2. The same change in funds-&-trusts raises that industry's multiplier from 2.9 to 4.3.

Given Connecticut's LQs in banking, securities and real estate, its multipliers are about what you'd expect—2.2, 2.7, and 2.2 respectively. But its multiplier for insurance, 3.1, is about 0.7 below the predicted value, while its multiplier for funds-&-trusts, 7.1, is 1.8 jobs higher than the model would suggest.

WHAT GOES UP MUST COME DOWN?

In an expanding economy, the multiplier process spurs a virtuous cycle of increased output, earnings and jobs. But when the economy falls on hard times, the multiplier shifts into reverse, so that the ultimate impact of a small reduction in economic activity is something worse than the initial drop.

That is a particularly worrisome possibility when the industry in question is financial activities, with its larger than average multipliers, and when the state under the microscope is Connecticut, with its higher-than-average concentration of jobs in the industry. How might Connecticut respond to a sucker punch square in the middle of the financial services industry?

Today's economic narrative shares many common threads with the last recession to shake the financial services industry, in the early 1990s. That rocky stretch was bracketed by a 1987 stock market crash that cleaved nearly 40 percent from the Dow and Hurricane Andrew's 1992 rampage through southern Florida and southwest Louisiana that cost the insurance industry billions. Throughout the

DEJA VU: HOW A 1990s-SIZED PUNCH IN FINANCIAL ACTIVITIES WOULD AFFECT CT JOBS AND EARNINGS

	Industry Jobs	% Decline	Direct Loss	Job Multiplier	Total Job Loss	Avg Earnings	Earnings Loss (Millions)
Banks	33,821	-8.5%	-2,875	2.2	-6,461	$53,050	-$343
Securities	50,547	-13.4%	-6,773	2.7	-18,219	$58,991	-$1,075
Insurance	74,550	-2.5%	-1,864	3.1	-5,786	$54,501	-$315
Trusts	9,036	-30.6%	-2,765	7.1	-19,632	$61,035	-$1,198
Real Estate	97,341	-16.7%	-16,256	2.2	-36,495	$31,994	-$1,168
Total	265,295	-11.5%	-30,533	2.8	-86,593	$47,333	-$4,099

SOURCE: *The Connecticut Economy*, based on the author's analysis of BEA data.

period, savings and loans collapsed in droves, following years of unsound real estate lending, and the real estate industry went into a tailspin as new home construction dropped from an annual rate of 1.8 million to 1.0 million units.

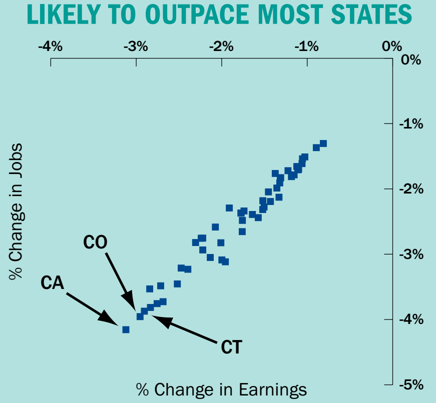
In percentage terms, the typical state suffered single-digit job losses in insurance and banking, but losses in the teens in real estate and securities. Connecticut lost half its workforce in real estate, one-third in banking and about 10 percent in insurance and securities. The state's job losses were aggravated by the post-Cold War shakeout in defense-related manufacturing, something that is unlikely to play a role in the current recession.

Suppose, for the sake of argument, that financial job losses in Connecticut this time around are held to the 50-state average of the 1990s. (In the '90s, industry job losses were uncorrelated with state LQs.) Direct industry losses would likely top 30,000, while multiplier effects would trigger additional reductions elsewhere of more than 55,000 (see table). So total job cuts could approach 90,000. Worker earnings could slump by $4 billion, and the state's take of tax revenue (which averages 9 percent for income, sales and other taxes) would drop nearly $375 million.

That estimated thumping to the budget is conservative, since earnings in financial activities are more likely to be taxed at a higher marginal rate than average. And the larger-multiplier securities industry is likely to take a bigger hit this time than is real estate, at least in Connecticut. Plus, the model doesn't include the more than 25,000 Connecticut workers who live in-state but commute to Manhattan, many of them to work jobs in financial activities that may be on the chopping block. Finally, we're assuming that the financial sector as a whole will fare no worse in this meltdown than it did in the last.

Under all these conditions, it is easy to see how the state might be facing a budget shortfall exceeding $1 billion in this fiscal year. Connecticut had planned for a 4.7 percent, or $800 million, increase in the state's budget from last fiscal year. Since earnings have been growing at a 4.7 percent annual rate in Connecticut this decade, that increase seemed entirely reasonable. But if earnings are flat instead, as they were both in 1991 during the earlier finance-related recession, and in 2001 after the dot.com boom, and if the slump in financial services costs the state another $375 million in tax revenue, then . . . well, you do the math. If the slump extends through the next fiscal year, the gap could easily exceed $2 billion.

CT JOB AND EARNINGS LOSSES LIKELY TO OUTPACE MOST STATES



SOURCE: *The Connecticut Economy*, based on BEA data.

IN THE SAME BOAT (ONLY MORE SO)

Assuming that Connecticut sustains industry cuts that are no more severe than in the "average" state is not just a wild guess. Financial activities losses in the early 1990s were uncorrelated with LQs, so states like Connecticut, with higher concentrations of jobs in financial services were no more likely than other states to suffer larger percentage job losses in the industry. That is cold comfort to the Nutmeg State, where a heavy concentration in financial activities brings with it large multipliers, so a given loss of jobs or earnings within financial activities has more dire consequences for the broader economy here than it does elsewhere.

As the accompanying scatterplot shows, the full impact of a financial sector meltdown is apt to be more serious in Connecticut than in nearly any other state, including New York. Only California and Colorado are likely to find the going tougher than Connecticut, with its projected declines in jobs (3.9%) and earnings (2.9%), and the resulting impacts on the budget. States with smaller industry concentrations and smaller multipliers will find more shelter from the impending storm.

Of course, no one knows whether the ongoing meltdown in financial activities will be more or less severe than last time. But the clouds on the horizon appear ominous, so the industry's slump in the 1990s, its worst in forty years, at least serves as a useful benchmark. Under even modest assumptions, the damage to Connecticut, with its high concentration of jobs in financial activities and large multipliers, is apt to be significant. With the stakes so high, no state should be rooting more loudly for the success of the financial industry rescue package than Connecticut, or praying more earnestly for a merciful end to the current business cycle.